

Completing Decentralization

Key Messages

Sub-National Governments (SNGs) in Indonesia lack the technical experience to improve expenditure management, enjoy limited 'own-source' revenues, and face central government subvention systems that fail to adequately address local needs and capacities. To complete the decentralization process, the Government of Indonesia (GoI) needs to adjust its funding models to support the efforts of SNGs to deliver services.

Key Action

1. **Enhance the intergovernmental finance system.**
 - ◆ Reformulate the DAU by removing the basic allocation.
 - ◆ Improve the management and usage of the DAK.
 - ◆ Transfer deconcentration funds to DAK as mandated by Law 33/2004, Article 108.
2. **Increase SNGs' own-source revenues** by devolving land- and building tax (PBB or pajak bumi dan bangunan) authority to the districts, while building the capacity of SNG institutions dealing with PBB.
3. **Strengthen sub-national finances** by creating creditworthy SNGs that are able to issue debt in the form of municipal bonds, for example. This can be done as a pilot project involving two SNGs and one local water supply utility or PDAM (Perusahaan Daerah Air Minum).
4. **Improve center-local relations by clarifying functional assignments.** Define clear and comprehensive divisions of authority and tasks (norms, standards, procedures, and criteria – NSPK or Norma, Standard, Prosedur dan Kriteria) across different levels of government in all sectors, and begin implementation in key service the areas: health, education, and infrastructure

Where Indonesia Stands Now

Notwithstanding the implementation of an ambitious decentralization agenda over the past decade, Indonesia still faces an ongoing, and as yet incomplete, governance transition from a centralized regime to a fully decentralized state. With the “big bang” decentralization of 2001, Indonesia went from being one of the most centralized countries in the world in administrative, fiscal and political terms, to one of the most decentralized. The transition has highlighted systemic weaknesses in the processes and capacity for formulating and implementing policy, and has made the process of implementing reforms far more challenging. Furthermore, decentralization

has changed accountability structures, as the division of roles and responsibilities between the various levels of government remains unclear in many spheres of activity.

Government effectiveness has also been limited by insufficient capacity and accountability of national and the local civil servants. The legislative framework for the division of functions between central, provincial and district/city governments is unclear and bureaucratic accountability is limited by rigid civil service rules. The effective promotion of Indonesia's development agenda is hampered by weaknesses in the mechanisms and framework for coordinating the formulation and implementation of policies and programs within and across the different branches of government. Service delivery

limitations are also attributable to confusion about roles and responsibilities between the central ministries and local governments, and extremely limited horizontal coordination across local governments.

The role of SNGs in public investment and economic development is increasing. Decentralization has transformed Indonesia’s governance and economic landscape. SNGs have become major players in service delivery, and most regions now have enough resources to make a real difference in the lives of their citizens. Indonesia’s 524 local governments, comprised of 491 districts and 33 provinces, undertake one-third of public spending and manage half of all public investments (see Figure 1). Even regions considered fiscally poor now spend an average of US\$425 per capita annually, and saw a 75 percent increase in their DAU transfers in 2006. With this in mind, Indonesia’s main development challenge is to ensure that existing resources are channeled and used effectively, and that adequate own-source revenues are generated at the SNG level, rather than focusing on the transfer of significant additional resources to poor areas.

The key role of the DAU is to equalize fiscal capacities across districts and provinces in order to finance their expenditure needs. The GoI recently removed the “hold harmless” condition so that regions that have substantial fiscal capacity are no longer receiving DAU allocation, leaving the government larger fiscal space to increase allocations to the poor regions. Much of the DAU is earmarked for civil service wages (basic allocation) so local government expenditures are dominated by administrative costs: salaries alone account for close to 30 percent of SNG budgets. There is little incentive for SNGs to streamline their civil service costs and shift spending to capital

expenditures as long as the central government continues to pay the full cost.

While SNGs in Indonesia manage a large share of public expenditures, their ability to create own-source revenues (Pendapatan Asli Daerah-PAD) remains weak. Own-source revenue accounts for an average of only 17 percent of SNGs’ revenues (Figure 2). The composition of PAD to SNG annual budgets (APBD - Anggaran Pendapatan Belanja Daerah) was between 30 percent and 40 percent for the provinces, and between five percent and 10 percent for kabupaten/kota: taxes and user charges accounted for the largest portion of PAD.

The central government currently administers the relatively efficient property tax, including setting rates and evaluations, although it provides 92 percent of the proceeds to district governments as part of Shared Revenue Funds (Dana Bagi Hasil-DBH). The statutory property tax rate is between 0.1 percent and 0.2 percent, one of the lowest in the world, and collection capacity is weak.

Policy Priorities for a Rising Indonesia

The top priority for the new administration is to complete a roadmap laying out key principles and features of the country’s multi-tier government structure that balances the need for central oversight and local autonomy, while ensuring equity and efficiency. This roadmap should be flexible, and will need to be reviewed regularly. Given the evolving political and administrative

Figure 1: Government Expenditure Patterns

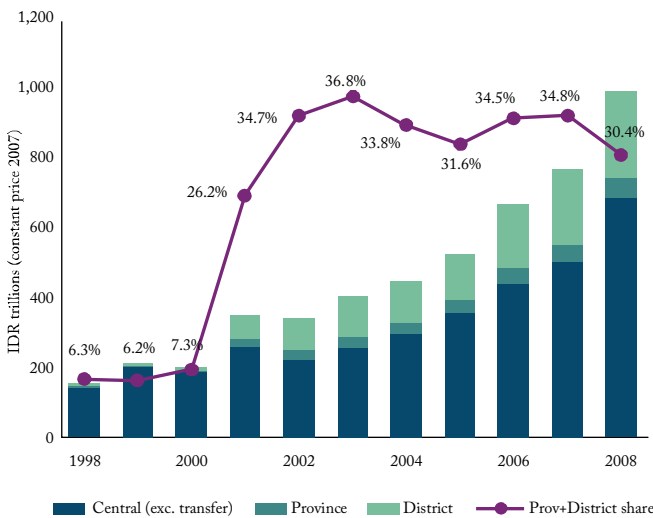
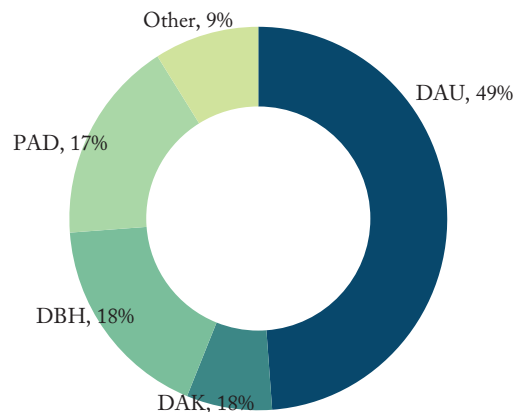


Figure 2: SNG Sources of Revenue



Source: MoF and WB staff estimates, 2009

context, it is unrealistic to expect a detailed and fully worked out decentralization policy. Instead, it will remain a work in progress, with refinements introduced as it is implemented.

Developing a roadmap will also be much easier once an inter-ministerial coordination mechanism is established to provide greater leadership and cohesiveness to the process. The roadmap should answer the following questions:

- ◆ What are the key features and principles of the decentralization agenda, to the extent that there is already broad consensus?
- ◆ What are the key outstanding issues requiring reform, including defined priorities and a time frame for reform?
- ◆ How will detailed policies be developed within Indonesian institutions, and what will the consultative approach look like?
- ◆ What legal instruments/ architecture will be adopted?
- ◆ What are the support modalities and magnitude of resource requirements, including those of Indonesia's development partners?
- ◆ What are the capacity development principles?

The following priority actions are needed to complete the decentralization process:

1. Enhance the intergovernmental finance system.

- ◆ Improve the allocation, management, and use of both DAU and the DAK resources while strengthening monitoring and evaluation. The GoI will have more DAU resources available for equalization purposes after removing the basic allocation, as it did with the "hold harmless" provision. A reduction in the DAU funds pool reserved for salaries will create more fiscal space and allow more resources to be allocated to reflect SNG expenditure needs. In addition, as the amount of DAK increases, the government needs to strengthen the management and usage of DAK, both at central and SNG levels. To strengthen the monitoring and evaluation of DAK, it should improve the current mechanism for analyzing financial and technical reporting and introduce well-suited techniques to conduct field verification. This is the key to determining the efficacy of DAK expenditures, and supporting local government reforms.
- ◆ Base future allocation of DAK funds on medium-term expenditure frameworks in order to align allocations more closely with the capital expenditure requirements of SNGs. The government should also explore ways to make the DAK more targeted and bring allocation decisions closer to the SNGs.

It should then build in an incentive mechanism, whereby high performing SNGs are rewarded with additional DAK.

2. Increase SNGs' own-source revenue.

- ◆ Devolve land and building taxes (PBB) to the regions. The government is amending the law on regional government taxes and fees to allow SNGs to generate more own-source revenues. Unlike most decentralized countries, Indonesia has not transferred significant tax authority to SNGs, thereby creating excessive dependence on central transfers. A pilot should be implemented in one province in order to improve the management of PBB, and to make it a truly SNG-administered and collected tax.
- ◆ Use the proposed amendments to Law 34/2000 on Regional Taxation as an opportunity to address some of the difficult issues around own-source revenues. The new law, which attempts to move from a negative list on taxes and fees to a positive list of preferred revenue sources, should restrict the proliferation of uneconomic local government interventions. It should also address measures to control administration or rates of property taxes to be delegated to SNGs.

3. Strengthen sub-national finances by creating creditworthy SNGs.

- ◆ Develop a comprehensive framework to increase SNG access to credit. District and provincial governments play a key role in soliciting public investment, particularly in infrastructure where investment levels have lagged: total outstanding sub-national debt is just 0.14 percent of GDP. While many SNGs run surpluses, they have insufficient financial resources to meet investment needs. The framework should support local infrastructure finance and service delivery by addressing the overly complicated rules governing SNG borrowing, including regulations that limit borrowing for non-revenue producing projects. The problem of outstanding arrears affecting several SNGs needs to be addressed comprehensively, and the use of intercept mechanisms for SNGs that repeatedly fall into arrears should be put into effect promptly.
- ◆ Support efforts by at least two SNGs and one PDAM to issue debt in the form of bonds and/or loans. A first step in the process will be to help SNGs obtain independent Financial Management Assessments (FMAs) and credit ratings. The government should help at least the 10 largest cities, including two provinces, to obtain FMAs and credit ratings, and provide capacity building to improve financial and debt management at the SNG level.

4. **Improve the framework governing center-local relations by clarifying functional assignments.**

Define clear and comprehensive Standard Operating Procedures for the division of authority and tasks (NSPK) across different levels of government in all sectors, starting with basic service provisions: health, education and infrastructure. Article 9 of GR 38/2007 (Division of Authority) instructs central ministries/agencies to form NSPK on the implementation of SNG functions within a two-year period of issuing of the regulation. At present, some efforts are being made to elaborate central government criteria. The Ministry of Health has started an initiative to lead the way by preparing the technical guidelines for the division of responsibilities across levels of government.

How The World Bank Can Help

Decentralization Support Facility (DSF) program.

The World Bank and the GoI are jointly responsible for coordinating the DSF's programs and activities. The World Bank acts as the DSF multi-donor trust fund administrator. Its principal purpose is to support the government's decentralization agenda, particularly as this pertains to improved service delivery.

Public Expenditure Analysis and Capacity

Harmonization (PEACH). The World Bank will continue its efforts to improve public financial management at the provincial and district levels through the PEACH program. The overall program goal of PEACH is to generate knowledge for policy-making to improve the services provided by Indonesia's local governments. To date, PEACH has been completed in Papua, Aceh, Gorontalo, and East Nusa Tenggara, and is ongoing or planned for

West Nusa Tenggara, South Sulawesi, North Sulawesi, and Maluku provinces. The program helps committed SNGs to increase the effectiveness of their development planning, budget formulation and implementation.

Improving DAK management and usage. The World Bank is supporting the GoI's efforts to strengthen the management and usage of the DAK transfer by SNGs. The program seeks to strengthen existing SNG institutions dealing with DAK transfers, in order to increase the effectiveness of planning processes and the impact of budget expenditures. The program will be piloted in up to five provinces, focusing on infrastructure (water, roads and irrigation).

Developing SNG capital markets. The Bank Group will provide support to the DG Fiscal Balance, Ministry of Finance (MoF), and develop a comprehensive framework for SNG borrowing. In particular, MoF has sought guidance on setting up a system of SNG financial assessments and credit ratings, starting with four large cities and one province. The assistance includes analyzing financial and operational data and helping SNGs improve their financial management. The World Bank has helped DKI Jakarta obtain an initial FMA and credit rating, and will work to prepare Jakarta for its first bond (or direct debt via loan) issue.

Strengthening the devolved property tax (land and buildings) to the Districts. The World Bank supports the GoI's devolution of the property tax to district governments and has begun discussions with MoF about how it can support measures to make the PBB an effective source of revenues collected and managed by SNGs. Pilot implementation in up to two provinces is recommended in order to enhance the effectiveness of district-level property tax administration.

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